In the Supreme Court of the United States,

OCTOBER TERM 1910.

LAWRENCE E. SEXTON, as trustee in bankruptcy of Kessler & Co., Appellant, *vs.* LEOPOLD LOUIS DREYFUS and others, composing the firm of Louis Dreyfus & Co., Appellees.	No. 662
LAWRENCE E. SEXTON, as trustee in bankruptcy of Kessler & Co., Appellant, *vs.* LLOYDS BANK, LTD., Appellee.	No. 663

APPEAL FROM THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT.

APPELLANT'S BRIEF.

Statement of Facts.

The appeal first above entitled is from a final order of the Circuit Court of Appeals for the Second Circuit, affirming an order of the District Court for the Southern District of New York which in its turn affirmed an order of the referee, allowing the claim of the appellees Louis Dreyfus & Co., for the purpose of a dividend under section 57 (h) of the Bankruptcy Law, at the sum of $204,454.74. (Order of Circuit Court of Appeals, rec., fols. 20-21; Order of District Court, rec., fol. 14).

This amount includes several claims, some of which were secured and some unsecured. Those involved in this appeal are set out in the findings of the Circuit Court of Appeals (rec., fols. 23-25). The referee allowed these claims for dividends at $135,961.61, of which $28,691. is interest accruing *subsequent* to the filing of the petition in bankruptcy against Kessler & Co. (Findings fifth-seventh, Dreyfus, rec., fols. 24, 25).

The appeal second above entitled is from a similar order of the Court of Appeals affirming an order of the District Court which affirmed an order of the referee allowing a claim of Lloyds Bank, Ltd., for the purpose of dividends under section 57 (h) of the Bankruptcy Act, at $4,520.81, of which $4,433.69 is interest accruing *after* the filing of the petition in bankruptcy. In the Lloyds Bank case the findings of the Circuit Court of Appeals will be found at folios 32 to 34 of the record in that case.

In respect to the matters involved in this appeal, both Dreyfus & Co. and Lloyds Bank, Ltd., were

secured creditors. The petition in bankruptcy was filed against Kessler & Co. on November 8, 1907. Both creditors filed claims against the estate in due course after the filing of the petition, enumerating their securities pursuant to section 57 (a). (Dreyfus rec., fol. 23, finding second; Lloyd's Bank, rec., findings second and third, fol. 32). Dreyfus & Co. did not sell their securities until thirteen months later; that is to say, in December, 1908. (Dreyfus rec., findings third, fol. 24). The amount realized on the sale of the security was insufficient to pay both principal and interest. Dreyfus & Co. claimed to have applied the proceeds of the security first to the payment of interest subsequent to the filing of the petition, amounting to $28,691, and that under 57 (h) they should be allowed dividends on the difference between the principal of their claims and the remainder of the proceeds of the security, to-wit, $135,961.61 (Dreyfus rec., fol. 24, finding sixth).

Lloyds Bank finally liquidated its security on July 2, 1908. The proceeds were insufficient to pay both principal and interest. Lloyds Bank claimed to have applied the proceeds to the payment of interest first, and that it should be allowed dividends under 57 (h) on the difference between the principal of its claim and the remainder of the proceeds of the security.

The trustee opposed the allowance of these claims on this basis, filing a petition for the reexamination of the claims and the disallowance of the interest. The only question in controversy between the trustee and the creditors was the interest allowed *subsequent* to the filing of the petition. The referee included the interest in the claim from which under 57 (h) the value of the

securities should be deducted to determine the "unpaid balance" on which dividends should be paid; that is to say, he added the interest accruing subsequent to the date of filing the petition to the amount of the claim on that date, and deducted the proceeds of the security from the total. (Dreyfus rec., fol. 24, finding seventh; Lloyds Bank rec., fol. 33, finding seventh). The referee then on the trustee's petition certified to the District Court the following question:

> "Is a creditor holding security which is liquidated after the filing of petition in bankruptcy, entitled to interest upon his claim after the date of the filing of said petition, where the proceeds of the sale of the security are inadequate to pay the face of the claim?"

This question has been answered in the affirmative by a majority of the Circuit Court of Appeals (Judge Ward dissenting) (Dreyfus rec., fols. 17-20; Lloyds Bank rec., fols. 26-29), and the claim has been allowed by the Circuit Court of Appeals as determined by the referee. (Finding of fact seventh and conclusion of law; Dreyfus rec., fols. 24, 25; Lloyds Bank rec., fols. 33-34).

The question does not appear ever to have been decided either under the present Bankruptcy Law or any of the earlier bankruptcy acts of the United States, but in England, in *Ex parte* Wardell, decided in 1787, and reported in Cooke's Bankruptcy Law, 4th Ed., 1799, p. 181, the point was ruled in accordance with the trustee's contention in this case, and has been repeatedly reaffirmed by most distinguished judges under subsequent English bankruptcy laws, the latest decision being that of Mr. Justice Vaughn Williams in the case of *In re* Bonacino (1894), 1 Manson 59.

POINTS.

I.

The Supreme Court has Jurisdiction of the Appeal.

The appeal is taken under Bankruptcy Law sec. 25 (b) (1) from a decision of the Court of Appeals allowing a claim in which the amount in controversy exceeds the sum of $2,000.00, and a federal question is involved.

(*a*) The Circuit Court of Appeals took jurisdiction of the appeal from the District Court under section 25 (a) (3) as one from a judgment allowing a claim of $500.00 or over.

(*b*) Confining the "amount in controversy" to the interest in dispute, it exceeds $2,000.00 in each case.

(*c*) A federal question is involved from which if decided by a State Court an appeal would lie to the Supreme Court of the United States, to-wit, the construction of sections 57 (a) and (h), 63 and 67 (d) of the Bankruptcy Law. This is the only question. It was specially raised by the trustee by his petition for the disallowance of the interest accrued subsequent to filing the petition, and the decision denies a right claimed by him under the Bankruptcy Law.

(*d*) The jurisdiction is directly supported by the following cases:

Pirie *v.* Chicago Title & Trust Co., 182 U. S., 438;
New York National Bank *v.* Massey, 192 U. S., 138;
Western Tie & Timber Co. *v.* Brown, 196 U. S., 502;
Hiscock *v.* Varick Bank, 206 U. S., 28;
Coder *v* Arts, 213 U. S., 223.

The appellant relies in each case upon the third and fourth assignment of errors, the fourth being merely a more definite statement of the third:

> "*Third.*—In that the said Circuit Court of Appeals decided that a creditor holding security which is liquidated after the filing of the petition in bankruptcy is entitled to interest on his claim after the date of the filing of such petition, where the proceeds of the sale of the security are inadequate to pay the face of the claim.
>
> *Fourth.*—In that the said Circuit Court of Appeals decided that the portion of the appellees' secured claims upon which they should be paid dividends under section 57 (h) of the United States Bankruptcy Law should be determined by adding to the claims as allowed at the time of filing the petition in bankruptcy interest subsequently accruing between the date of filing the petition and the last sale of the collateral, and by crediting upon such total principal and interest the total proceeds of the sale of the collateral and the earnings thereof, if any, collected thereon after the filing of the petition; and that dividends should be paid from the bankrupt estate upon the remainder." (Dreyfus rec., fol. 29; Lloyds Bank rec., fol. 38).

II.

The Bankruptcy Law forbids the allowance of interest on provable debts after the date of the filing of the petition.

A. The following provisions of the law must be considered:

> "Sec. 57. Proof and Allowance of Claims—
> "(a). Proof of claims shall consist of a state-
> "ment under oath, in writing, signed by a
> "creditor setting forth the claim, the con-
> "sideration therefor, and whether any, and
> "if so what, securities are held therefor, and
> "whether any, and, if so what, payments have
> "been made thereon, and that the sum
> "claimed is justly owing from the bankrupt
> "to the creditor.
>
> * * * * * * * * *
>
> "*h* The value of securities held by secured
> "creditors shall be determined by converting
> "the same into money according to the terms
> "of the agreement pursuant to which such
> "securities were delivered to such creditors
> "or by such creditors and the trustee, by
> "agreement, arbitration, compromise, or
> "litigation, as the court may direct, and the
> "amount of such value shall be credited upon
> "such claims, and a dividend shall be paid
> "only on the unpaid balance."

> "Sec. 63. Debts which may be Proved.—
> "a—Debts of the bankrupt may be proved
> "and allowed against his estate which are
> "(1) a fixed liability, as evidenced by a judg-
> "ment or an instrument in writing, absolute-
> "ly owing at the time of the filing of the pe-
> "tition against him, whether then payable or
> "not, with any interest thereon which would

"have been recoverable at that date or with a "rebate of interest upon such as were not "then payable and did not bear interest; * * * "(4) founded upon an open account, or upon "a contract express or implied."

The corresponding provision of the law of 1867 (section 19) was similar, except that in the earlier act the date of adjudication was adopted as the period at which the debt proved must be due instead of the date of filing the petition.

Section 57, subsection (a), makes no distinction between secured and unsecured creditors in respect to proof of claims. All claims secured or unsecured must be proved in accordance with that provision, and the secured creditor must enumerate his securities. Reading section 57 with section 63, it is clear that the debt which any claim asserts must, in order to be *provable*, be one existing at the time of filing the petition. Such is the settled construction (Collier on Bankruptcy, 7th Ed., p. 701, and numerous cases cited in note 22). No other claims are *provable debts*. Interest accruing after petition filed is obviously not a debt existing at the time of filing, and so by the express provisions of the act is excluded from proof.

This is further illustrated by the official forms for proof of debt (See official forms 31 and 32). The forms both for unsecured and secured creditors require the statement that the debt proved "existed at and before the filing of said petition."

In respect to secured creditors, section 57 (h) provides further that the value of securities held by such creditors shall be determined by converting the same into money, and that "the amount of such value shall be credited upon such claims, and a dividend shall be paid only on the unpaid

balance." What "claims" are here referred to? Obviously, the claims previously mentioned in the same section, 57 (a); that is to say, claims that may be proved; in other words, provable debts under section 63, which must be debts existing at the time of filing of the petition. Subsection 57 (h) does not provide that after the secured creditor has satisfied his lien on his securities to the full extent of the proceeds he may prove for any unsatisfied balance of the indebtedness of the bankrupts to him, but that the value of the securities shall be credited upon the *claim;* that is upon the *provable debt,* which is the debt existing at the date of filing the petition; and that upon a balance thus ascertained the creditor may receive dividends.

When, now, a secured creditor who liquidates his security long after the date of filing of the petition (as, for example, thirteen months in the Dreyfus case, eight months in the Lloyds Bank case), and whose security has proved insufficient to pay both the principal and interest of his debt, comes into a court of bankruptcy to claim dividends on the unsatisfied balance, and determines the balance by adding to the principal all the interest which has accrued between the date of petition filed and the date of the sale of the securities, and deducts the proceeds of the sale from such total principal and interest, how can the court allow dividends on this balance without allowing a non-provable debt?

B. It is quite true that as between a secured creditor and his debtor the former on selling the security has, if he seeks nothing under the Bankruptcy Law, an undoubted right to apply the

proceeds first to the payment of interest on his claim, and, if the proceeds are insufficient to satisfy the whole claim, has still a good claim against the debtor for the full balance, both principal and interest. In these appeals, therefore, the creditors argue that they had a lien upon the collaterals for both principal and interest, and that section 67 (d) of the Bankruptcy Law protects this lien.

Subsection 67 (d) provides that liens given and accepted in good faith, and for a present consideration, shall not be affected by the act. This subsection is purely declaratory. It is obviously inserted in section 67 out of caution, because the other parts of that section invalidate so many kinds of liens in most sweeping language. The provision contained in 67 (d) is intended simply to preserve the lienor's interest in the property which is the subject of the lien, and to assure to him full right to enforce his lien unembarrassed by the act. The trustee cannot attack such a lien; it is not affected by the four months' provisions, or by any of the general clauses of 67 (c), (e) and (f). Subsection 67 (d) must be reconciled with 57 (a) and (h) and 63, and it is an inadmissible construction to hold (as has been held in these cases) that section 67 (d) authorizes the appellees to claim dividends on a debt or claim otherwise non-provable.

As long as the secured creditor stays outside the bankruptcy act (as the English court puts it "sits on his security"), and claims nothing under the bankruptcy law, he is entitled to the full proceeds of his securities, and to collect from them all the interest and principal of his debt, if he can. Section 67 (d) protects him in these rights. If the proceeds are sufficient to pay both the principal

and interest of his claim, nothing in the act can be invoked to restrict such payment.

When, however, such a secured creditor comes into the bankruptcy court asking for dividends on an unsatisfied balance, his position becomes quite different. His claim has then ceased to be a secured claim at all, and is really an unsecured claim for the diminished amount. He is not asserting a lien then, but is invoking the aid of the Bankruptcy Law to obtain something out of the general estate; and the correct construction of the act is that in respect to this unsatisfied balance he must stand on the same ground as other general creditors who had no security, and who are not allowed interest after the date of filing the petition. This distinction is well recognized in the decision of the Circuit Court of Appeals in Coder *v.* Arts, 152 Fed. Rep., 943 (afterwards affirmed without considering this point in this court in 213 U. S., 223). In that case the proceeds of the security were sufficient to pay both principal and interest, and in considering the question the Circuit Court of Appeals said (p. 950):

> "Another rule might prevail if the pro-
> "ceeds of the mortgaged property were insuf-
> "ficient to pay the mortgage debt and the in-
> "terest in full, and the mortgagee was seek-
> "ing to collect an unpaid balance by sharing
> "with the other creditors in the distribution
> "of the comon property. He might not be
> "entitled then to recover from the proceeds
> "of the common property interest upon his
> "debt to any later date than the unsecured
> "creditors would recover interest upon their
> "claims."

C. The Bankruptcy Law in fixing the date of the filing of the petition as the date at which in-

terest shall cease, seeks to treat all creditors alike. For this purpose some date must be selected as the common due date. The present law adopts the date of the filing of the petition. The act of 1867 adopted the date of the adjudication, and under both acts claims are to be allowed interest if past due, and are to be rebated if not due. Perfect equality is obtained by the selection of a uniform date.

The reason of the rule is stated in *Ex parte* Bennet, 2 Atk. 527, as follows:

> "Commissioners, after a man becomes "bankrupt, compute interest on debts no "lower than the date of the commission, be- "cause it is a dead fund, and in such a ship- "wreck if there is a salvage of part to each "person in the general loss it is as much as "can be expected."

The right of the creditor, secured or unsecured, to a proportionate share of the assets of the bankrupt estate is a right *in rem* similar to the right of creditors of an insolvent national bank. This share becomes fixed at the statutory date and is not subject to increase or decrease thereafter, except as all shares may vary with changes in the value of the assets. In cases of insolvent banks it is well settled that a secured creditor cannot have interest upon his claim allowed from the assets subsequent to the date of suspension (Chemical Natl. Bank *v.* Armstrong, 59 Fed. R., pp. 378-79; Merrill *v.* Natl. Bank, 173 U. S., 131, pp. 140-41; White *v.* Knox, 111 U. S., 784, p. 787). The insolvent bank's creditor can prove for his whole debt with interest to the date of suspension irrespective of his security; but in bankruptcy he must enumerate his security and deduct its

value from the provable claim. If he desires to prove for his whole claim, he must surrender his security.

The same result would be reached (assuming a uniform rate of interest) by allowing all creditors to receive interest until the final liquidation of the estate. This, however, would involve a large amount of clerical labor in estimating interest on every claim and on different amounts at the time of every dividend payment. But, if the statutory restriction had not been enacted, unsecured creditors would have been in a position of perfect equality in respect to interest with secured creditors, according to the position which the appellees now assert. Can it be a sound construction of the Bankruptcy Law to hold that Congress intended to discriminate against general creditors as compared with secured creditors by depriving the former of interest subsequent to the filing of the petition, but allowing it to the latter, if the proceeds of their securities should not be sufficient to pay their claims, both principal and interest, in full? Are not the secured creditors sufficiently compensated for their forethought in obtaining security if they are allowed to realize upon it, and, where it is inadequate, to obtain dividends on a balance estimated in accordance with the provisions of sections 57 and 63, and on a complete equality with the unsecured creditors?

Creditors under the provisions of the Bankruptcy Act have twelve months within which to prove claims. Is it a possible construction of the act to hold that a creditor who has some security may allow interest to accumulate for eleven months, then sell his security, and if the proceeds are only adequate to pay the interest, prove the claim as if he had never had any security at all?

The weakness of this contention appears from the result which makes the provable debt depend upon the date when the security is sold. Thus, if the claim is $100,000 and the security $6,000, by selling at the end of two months, the creditor can prove for $95,000 ($100,000 principal, $1,000 interest less $6,000 security). By waiting a year, he may prove for $100,000, the interest subsequent to bankruptcy wiping out the whole of the security.

It is argued on behalf of Lloyds Bank that the trustee can apply to the court to enforce a speedy liquidation of the collateral, and the case of Hiscock *v.* Varick Bank, 206 U. S., 28, is cited in support of this statement. We submit, however, that an examination of that case will show that the court did not mean to say that a creditor could be compelled to sell his collateral before the expiration of the period allowed by the statute for filing claims, where his contract leaves him entire liberty to determine the time of realizing on his security.

III.

A secured creditor cannot evade the provisions of the Bankruptcy Law forbidding the allowance of interest, accruing subsequent to petition filed, by applying the proceeds of his security first to the payment of interest.

Consider the case of a secured creditor, the proceeds of whose security are insufficient to pay the whole of the interest accruing between the date of filing the petition and the date of the sale of the security. Will he be entitled then, in stating his claim for the purpose of having determined the balance upon which he shall receive dividends under 57 (h), to add to the principal the interest accrued subsequent to the filing of the petition, and fix the balance by deducting from this total the proceeds of his security? Obviously, he would be under the method adopted by the referee and approved and adopted by the Circuit Court of Appeals (See its findings, Dreyfus rec., fols. 23-25; Lloyds Bank rec., fols. 32-34). The learned district judge whose opinion has been adopted by the Circuit Court of Appeals shies at this conclusion (See his opinion printed in the Lloyds Bank rec., fols. 14-18). At page 11 he says:

> "Of course in a case in which the security "was not sufficient to pay the interest which "accrued upon the claim from the date of the "adjudication until its liquidation, I do not "mean to be understood to hold that the "creditor could prove for any part of that "interest remaining unpaid. In no event

"could the creditor prove for more than the "amount of the claim at the time of the ad- "judication. I only decide that the implied "right given him under the original contract "of marshalling the security in the first in- "stance against the interest is not taken from "him by the bankruptcy of the debtor."

If it is the true construction of the Bankruptcy Law (as hereinbefore argued, and as the learned district judge seems to assume in this quotation from his opinion) that the Bankruptcy Law forbids the allowance of interest after the date of petition filed to any creditors secured or unsecured, applying under the act for dividends, surely secured creditors cannot be permitted to escape this construction by such a simple device as applying the proceeds of their security, when deficient, first to the payment of interest not allowed by the act; that is to say, accruing subsequent to the filing of the petition. The best answer to this position seems to be that made by Mr. Lord Justice Vaughn Williams in the case of *In re* Bonacino, decided in 1894, 1 Manson 59, in which the facts were as follows:

A debt was secured by a bill of sale. The security was inadequate, and the creditor applied it to the interest upon his claim after the date of the receiving order, and claimed the balance against the estate The trustee rejected the claim and the creditor appealed.

The Court said:

"This appeal must be dismissed. Interest "ceases to run after the date of the receiving "order, and what can not be got directly, can "not be got indirectly by the creditor allocat- "ing the proceeds of a security first to the "payment of such interest."

This is accepted as the correct rule in Lowell on Bankruptcy, sec. 419, as follows:

> Interest on Secured Debt.—"If the security exceeds the debt, the creditor receives "interest until the settlement with the assignees whether by redemption, sale or "otherwise. There are *dicta* that if the creditor applies to the court for relief, the "practice is to stop interest at the date of the "adjudication; but this is not the law, *excepting as applied to the proof for a deficiency*. If there is such a deficiency, the "interest account can only be made up to the "date at which unsecured creditors make up "their accounts; that is to say, the secured "creditor shall not apply his security to interest accrued after the bankruptcy, and "thus prove a balance made up in part of "such interest."

IV.

The long established rule of the English Courts of Bankruptcy forbids the application by secured creditors of the proceeds of security to interest accruing after the date of the commencement of bankruptcy proceedings, if such creditors after the liquidation of the securities claim dividends on an unpaid balance.

The earliest cases are *Ex parte* Wardell, decided in 1787, and *Ex parte* Hercey, decided in 1792, reported in Cooke's Bankruptcy Law, 4th

Ed., 1799, p. 181; see also 2 Montague & Ayrton, appendix A; *Ex parte* Badger, 4 Ves., 165, decided in 1798; *Ex. parte* Ramsbottom, 2 Montague & Ayrton, 80. These earlier cases are reviewed in the opinion of the District Court, adopted by the Circuit Court of Appeals, and printed in the record in the Lloyds Bank case, fols. 14-19. Of the later cases see especially *In re* Savin; Law Rep. VII. Chan. App. Cas., 760; Quatermaine's Case, 1892, 1 Ch. Div., 639; *In re* Bonacino, 1 Manson 59; *ex parte* Lubbock, 9 Jur. N. S. Pt. 1, 854.

These authorities strongly support our contention that interest will not be allowed upon a secured claim after the date of bankruptcy.

The statute considered in *in re* Quartermain and *in re* Bonacino was the English Bankruptcy Act of 1883. By the provisions of that act, secured creditors were left free to deal with their securities just as they would have been entitled to deal with them if the act had not been passed. They were, of course, allowed also to prove their claims under the act. Rule 9 of the 2nd schedule ran thus:—

> "If a secured creditor realizes his security, he may prove for the balance due to him, after deducting the net amount realized."

This is, in substance, the same as section 57*h* of our present Bankruptcy Law, which provides, that when the value of the security has been ascertained pursuant to that section "the amount of such value shall be credited upon such claims, and a dividend shall be paid only on the unpaid balance."

There have been so many of these decisions in which opinions were handed down, by courts of

appeal as well as by courts of first instance, that it is plain the English courts are not relying upon an obscure precedent made many years ago, but that the rule is itself founded upon good sense and justice. It will not do to disregard it as a rule which, to quote the language of the District Court, "clearly arises through inadvertence" (Lloyds' Bank Rec., fol. 15). That argument might have been addressed to the Court of Chancery a hundred years ago, but when the ruling has been followed and reasserted so many times by so many courts, including judges so eminent as Loughborough, Eldon, Ellenborough and Westbury, it should be regarded as persuasive in the highest degree.

In *In re* Savin (Law Rep. VII Ch. App. Cas. 760) Lord Justice James said:

> "This rule has been repeated in the very same terms by every writer on the subject, and by every judge, with the exception perhaps of Mr. Commissioner Montagu's note to *ex parte* Ramsbottom (2 Mont. & A., p. 83 App. A). It seems to have been considered as the established rule in bankruptcy, and so it was laid down by Lord Westbury in the case already referred to. (*Ex parte* Lubbock, *supra.*)
>
> That being so it appears to me that we cannot go into any reasoning whether the rule is unjust or unreasonable, or alter the rule, or say that the rule is only to be applied in the same cases, in which it has been applied, or that the rule is not consistent with the existing state of circumstances.
>
> I believe, however, that if the question now arose for the first time I should agree with the rule, seeing that the theory in bankruptcy is to stop all things at the date of the bankruptcy, and to divide the wreck of the man's property as it stood at that time."

Mr. Montagu's criticism referred to in this quotation overlooks the distinction, which we regard as vital, between a creditor looking to his security to satisfy his claim, and one coming into bankruptcy to ask for a dividend in competition with other creditors.

B. Subsequent to the filing of the petition, and prior to the sale of their securities, Dreyfus & Co. received from dividends on the securities $14,704.00; and Lloyds Bank similarly received $3,292.28. (Dreyfus Record fol. 24; Lloyds' Bank Record fol. 33). The question arises,—what is the creditor to do with this sum if he is not allowed to claim any interest subsequent to the filing of the petition in bankruptcy? The English courts, while maintaining the rule that the proceeds of security cannot be applied in satisfaction of interest after the date of the receiving order,—where the total proceeds are insufficient to pay both principal and interest and the creditor seeks to prove for the deficiency,—do allow dividends or interest collected on the security subsequent to the date of the receiving order to be applied against interest after that date.

This exception to the general rule of the English courts of bankruptcy rests upon two decisions,—*In re* Penfold, 4 DeG. & Sm. 282, and *ex parte* Ramsbottom, 2 Mont. & A. 80. In the case of *In re* Quartermain, (1892) 1 Ch. Div. 639. Mr. Justice Stirling says (p. 649):

> "As regards the application of the income, I confess that if the matter were *res integra* I should have had some difficulty in holding that there was any difference between that and the proceeds of sale; but it appears to

> me that I am bound by the decisions in *ex parte* Ramsbottom and *ex parte* Penfold. Both cases were cited in *In re* Savin, and no doubt was cast upon them. I have made a careful search, and cannot find that the rule there laid down has ever been overruled."

In spite of the doubts expressed in the foregoing quotation the exception seems to rest on reasonable grounds, and is beneficial in the settlement of estates. It tends to restrain creditors from selling interest bearing security immediately, which would often be prejudicial to the general creditors. But the creditor *has a right* to sell his collaterals immediately after the bankruptcy of the debtor. If he does sell, he will have the proceeds, and will be entitled to the interest on the proceeds as his own property. If, then, when he refrains from selling (usually for the benefit of the estate) he is permitted to retain the dividends the securities earn, this is merely allowing him what he would have had if he had sold. Such a result does not appear to be inconsistent with the general rule excluding from provable claims or debts interest accruing after petition filed. It violates neither the equities of the unsecured creditors nor the policy of the Bankruptcy Law.

If, however, such application of the earnings of the security subsequent to the filing of the petition, seems too inconsistent with the policy of our Bankruptcy Law to be adopted, the result should not be permission to secured creditors to apply possibly even the whole proceeds of the security first to the payment of the interest accruing subsequent to petition filed, but rather to require the

application of both proceeds and earnings in reduction of the face of the claim.

For the foregoing reasons the order of the Circuit Court of Appeals should be reversed with costs.

October Term 1910.

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JAMES H. McKENNEY,

Supreme Court of the United States

October Term, 1910.

No. 662.

LAWRENCE E. SEXTON, as trustee in Bankruptcy of KESSLER & COMPANY,

Appellant,

against

LEOPOLD LOUIS DREYFUS, Louis Louis Dreyfus, and Charles Louis Dreyfus, composing the firm of LOUIS DREYFUS & COMPANY.

BRIEF FOR DEFENDANT-APPELLEES.

FREDERIC R. COUDERT,
Of Counsel.

L. MIDDLEDITCH CO., NEW YORK.

Supreme Court of the United States,

OCTOBER TERM, 1910.

No. 662.

LAWRENCE E. SEXTON, as Trustee in Bankruptcy of Kessler & Company,

Appellant,

AGAINST

LEOPOLD LOUIS DREYFUS, LOUIS LOUIS DREYFUS, and CHARLES LOUIS DREYFUS, composing the firm of Louis Dreyfus & Company.

Statement.

This is an appeal from a final order of the Circuit Court of Appeals for the Second Circuit affirming an order of the District Court for the Southern District of New York, which in turn affirmed an order of the Referee, allowing the claim of the Appellees, Louis Dreyfus & Co., for the purpose of a dividend under Sec. 57 (H) of the Bankruptcy Law for the sum of $204,454.74. Of this amount, $27,691 is in question on this appeal. *This sum of money represents interest upon claims secured by collateral, which interest accrued subsequent to the filing of the application in bankruptcy against Kessler & Co.*

The sole question raised by the appeal in this case is as to the correctness of the ruling of the Referee that interest accruing on secured claims subsequent to the filing

of the petition in bankruptcy could be chargeable against the proceeds of the collateral in arriving at the amount to be allowed as a claim against the bankrupt estate where the said proceeds are insufficient to pay the debt. The Referee on the petition of the Trustee certified the question to the District Court as follows:

> *"Is a creditor holding security which is liquidated after the filing of the petition, entitled to interest upon his claim after the filing of the petition in bankruptcy, where the proceeds of the sale of the security are inadequate to pay the face of the claim?"*

This question was answered in the affirmative by the Circuit Court of Appeals (Dreyfus, Rec., Fols. 17-20) and the claim allowed in accordance with this decision.

The question is raised in this Court by the third and fourth assignments of error (Dreyfus, Rec., Fol. 29). The Fourth assignment is simply an elaboration of the Third, which states the question concisely as follows:

> "THIRD.—In that the said Circuit Court of Appeals decided that a creditor holding security which is liquidated after the filing of the petition in bankruptcy is entitled to interest on his claim after the date of the filing of such petition, where the proceeds of the sale of the security are inadequate to pay the face of the claim."

The question does not appear to have been decided either under the former Bankruptcy Laws or under any of the earlier ones and there is thus no direct authority on the question.

The appellant apparently relies upon certain English cases, to which reference will hereafter be made.

Appellees' Position.

The appellant's contention seems to be that since the Bankruptcy Act forbids the allowance of interest on provable debts after the date of the filing of the petition

by a parity of reasoning a secured creditor should not be allowed to credit interest accruing subsequent to the date of bankruptcy against the proceeds of collateral when the total amount is insufficient to satisfy the claim.

To this appellees reply that the security, its method of liquidation and all the rights pertaining to the contract of lien are not and cannot be affected by the Bankruptcy Act and hence the secured creditor is entitled to have his contract carried out in the ordinary way and to credit upon the claim interest down to the time of the sale of the collateral. The denial of such right would violate the specific provision of the Bankruptcy Law and would be a direct impairment of contractual rights.

POINT I.

The rights of secured creditors are unaffected by the Bankruptcy Law and the proceeds of collateral are to be marshalled in the usual way.

The Bankruptcy Law provides as follows:

> "Claims of secured creditors and those who have priority may be allowed to enable such creditors to participate in the proceedings at creditors' meetings held prior to the determination of the value of their securities or priorities, but shall be allowed for such sums only as to the courts seem to be owing over and above the value of their securities and priorities."
>
> * * * * * *
>
> "h. The value of securities held by secured creditors shall be determined by converting the same into money according to the terms of the agreement pursuant to which such securities were delivered to such creditors or by such creditors and the trustee, by agreement, arbitration, compromise, or litigation as the court may direct, and the amount of such

value shall be credited upon such claims, and a dividend shall be paid only on the unpaid balance."

The Statutes thus provide two things as to secured creditors.

FIRST.—Their lien shall not be affected by a bankruptcy adjudication.

SECOND.—Their collateral shall be liquidated in accordance with the original contract unless they consent to some other arrangement.

The settled rule of law is and always has been that where a secured creditor sells his collateral he may so marshall the proceeds as to first credit himself with the interest down to date of sale and then credit the remainder in case of deficiency against the principal. It is, of course, for this remainder that he has a right to prove in bankruptcy, for the Section of the Statute, above quoted, 57e, specifically provides that this claim shall be "allowed for such sums only as to the courts seem to be owing over and above the value of their securities or priorities."

It is thus only necessary to fix the amount owing after the sale of securities and such sale being in accordance with the original contract or lien the creditor may allow himself interest.

The rule that the secured creditor is entitled to first credit interest on the proceeds of the security is elementary and was fully recognized in Story *v.* Livingston, 13 Pet., 359, 371. It must be read into the contract and is a part thereof.

When the creditor takes security for his claim he has a lien upon or rights in that security or its proceeds up to the total amount owing. When the security is liquidated, if it be less than the full amount, these rights necessarily cover interest due to date of the liquidation, which interest was a part of the original contract.

If appellants be correct the Bankruptcy Act would confiscate that portion of the secured creditor's rights in the

collateral represented by interest from the date of the adjudication down to the sale of the collateral. This was evidently not the intention of the Act and the Act should not be construed in a confiscatory sense.

While it is true that the ordinary creditor cannot have interest on his claim after he comes into bankruptcy, the claim of the secured creditor is not affected by this rule since his claim is only for the amount owing after the liquidation of his collateral.

If the original collateral agreement had provided for certain deductions in favor of the creditor as for instance for attorney's fees, can it be plausibly claimed that such allowance against the security would be in the slightest degree affected by the Bankruptcy Act?

Appellant's ingenious argument is summed up in his brief in the following sentences:

> "Reading Section 57 with Section 63, it is clear that the debt which any claim asserts must, in order to be *provable,* be one existing at the time of filing the petition. Such is the settled construction. * * * No other claims are *provable debts.* Interest accruing after petition filed is obviously not a debt existing at the time of filing, and so by the express provisions of the act is excluded from proof."

This we respectfully submit begs the whole question, which is how much shall be deemed to be paid by liquidation of the security, the remainder only being the amount provable. Until such liquidation takes place, that amount is necessarily not ascertained, and such liquidation must take place, under the very terms of the Statute, in accordance with the original contract creating the lien.

Must the lienor then abate the compensation for delay by allowing the whole face of the proceeds just as though he had sold the collateral the day the petition was filed? Has he not the right, when he comes to ascertain what he must allow, to use the methods agreed

on by the parties *ab initio?* Suppose the contract had allowed an attorney's fee out of the lien before credit was made of the balance, would bankruptcy affect that? If not, does the right to be paid for the delay in liquidation stand in a different category? If there be increase in the security, must the lienor allow it and yet get no credit for the delay in asserting his rights which alone made possible that increase?

If the rule is as contended for by appellant, it not only violates the original agreement but must necessarily tend, upon well-settled principles of human nature, to the lienor's butchering the securities at once. The fact that he will be allowed his interest as usual, notwithstanding the bankruptcy, would certainly tend, in the many cases of slow assets, to inducing delay and care in the sale of securities and consequent benefit to all classes of creditors.

Counsel for appellant admits the ordinary rule, but claims that where a secured creditor "comes into the Bankruptcy Court asking for dividends on an unsatisfied balance, *his position becomes quite different.* His claim has then ceased to be a secured claim at all and is really an unsecured claim for the diminished amount. He is not asserting a lien then, but is invoking the Bankruptcy Law to obtain something out of the general estate; and the correct construction of the act is that in respect to this unsatisfied balance he must stand on the same ground as other general creditors who had no security, and who are not allowed interest after the date of filing the petition." (Appellant's Brief, p. 11.)

This frank statement seems to us to admirably illustrate the fallacy of his argument and to sustain the correctness of the reasoning upon which the two lower courts predicated their decisions. True, when the secured creditor comes into bankruptcy, he must stand on an equal footing with the other creditors, but this begs the very question at bar.

For what does he come into bankruptcy?

For the "diminished amount."

What is the diminished amount?

The amount due him after the sale of the securities in accordance with the original contract or lien. That amount is to be determined in precisely the same way as though there had been no bankruptcy. The lien is nowise affected by the adjudication and the method employed in this case for ascertaining the diminished amount is the method which Appellant admits would have been proper in the event that no bankruptcy had taken place. He points out no Statute which in any way affects any change in the original arrangement, or the usual and proper method of liquidating collateral and charging the proceeds against the principal debt. On the contrary the Statutes cited make it evident that the intention of Congress was to leave all this as before.

It is thus only after the original collateral agreement has been carried out, unaffected by the bankruptcy, that the diminished amount (*i. e.*, the provable claim) is ascertained and liquidated and the secured creditor then ceases to be in the secured class and comes into bankruptcy on a parity with the other creditors. Any other result nullifies the Statutes and can only be reached by a confusion of thought and failure of classification.

The argument that all creditors must be on an equal footing is perfectly sound, but in this case completely non-probative and irrelevant. Equality is not identity. Secured creditors are in a different class and so long as secured do not stand upon a parity with the other creditors. When the security is exhausted (according to the terms of the agreement pursuant to which such securities were delivered to such creditor) then and then only they become, for the balance, ordinary creditors. Then and then for the first time only the rule of equality applies to them.

The reasoning that because of their taking advantage of the act of bankruptcy to prove the residuum of their claim after the sale of the collateral, they are no longer entitled to interest down to the date of the sale of the collateral, is another method of stating that they are to

waive rights under the collateral agreement, because they elect to come into bankruptcy. This is merely arguing that Congress did not mean what it said in Sec 57 (e) and (h). If there be anything ambiguous in these sections, we are unable to see in what the ambiguity consists. The evident intention of Congress to leave the secured creditor in precisely the same position that he was in, and then allow him to prove for the "diminished amount" as an ordinary creditor, seems to be as clear and precise as language (at least English language) can make it.

The secured creditor, Appellant reasons with subtilty and at length, is virtually penalized because he comes into bankruptcy. He says:

> "As long as the secured creditor stays outside the bankruptcy act (as the English court puts it, sits on his security), and claims nothing under the bankruptcy law, he is entitled to the full proceeds of his securities, and to collect from them all the interest and principal of his debt, if he can." (Appellant's Brief, p. 10.)
>
> "Section 67 (d) protects him in these rights. *If the proceeds are sufficient to pay both the principal and interest of his claim, nothing in the act can be invoked to restrict such payment.*" (Appellant's Brief, p. 10.)

If this be true we must find something in the Act which changes his rights under the agreement if he choose to avail himself of the bankruptcy. We have searched the Statutes in vain and find nothing.

Appellant's reasoning that unsecured creditors cannot prove for interest after adjudication, seems to us to have no bearing upon the case for the reasons above stated.

The fact that this case is one of first impression in this Court, and is to be submitted without oral argument—leads us to repeat the same reasoning at perhaps

somewhat tedious length, but in slightly different and more concise form, as follows:

The original contract creating the lien is in no wise affected by the bankruptcy law. That contract comports the ordinary rule of marshalling interest first, and then principal. The creditor when he sells the security under such rule fixes the amount still owing to him, which amount becomes the provable claim.

Can there be the slightest question that this would be so, were the rule of marshalling written into the original agreement? But what difference can this make, since this general rule of law is admittedly part of the original agreement, and Congress by express provision declares the liquidation of the security to be pursuant to the original agreement, *i. e.*, just as though there had been no bankruptcy. This lien then is one for interest as much as for the principal sum. The theory, then that equality among creditors, under the bankruptcy Act, prevents the secured creditor from claiming such interest can have no application since the security itself was given as much for the interest as for the principal; as well claim that the Bankruptcy Act affects secured creditors' right to payment of principal from the proceeds of the security.

POINT II.

The English cases. The backbone of appellant's position seems to be certain English adjudications, fixing the rule as he contends for it These are inconsistent, illogical, unsound and hence non persuasive.

The bearing of the English cases as well as the whole question, was so ably and exhaustively treated in the opinion of the learned District Judge (printed as an appendix hereto), upon which the Circuit Court of Ap-

peals rested its decision, that we can say little in regard thereto that would not be repetitious.

An examination of the English cases, however, shows that the older cases adduced no reason for the rule, nor do there appear to be any statutory provisions precisely similar to our own, expressly providing that liens should be unaffected by bankruptcy proceedings.

The old English rule seems to be largely predicated upon a somewhat ambiguous order of Lord Loughborough, which having been interpreted by lawyers in the sense contended for by the appellant, has with true English conservatism been followed with little or no discussion.

In *ex parte* Ramsbottom, Montague & Ayrton, Vol. II, 1836, it is held that an equitable mortgagee is entitled to compute interest up to the time of bankruptcy as against his security. That in principle at least the reasoning of the Courts below in this case is sound, appears from the opinion of Sir George Rose:

> "It is unquestionable that so far as proof is concerned interest stops at the date of a fiat; *but where there is a security interest is regulated by the contract.* Lord Eldon's order is silent as to what are to be the rights of the parties after the sale, because it was not anticipated, but that the sale would be instanter when the rents, &c., would belong to the vendee. It is generally understood that persons in any way indemnified are entitled to interest subsequent to the fiat. Here the respondent (independently of being mortgagee) advances money to his firm and is to be indemnified under the deed; he therefore on that ground is entitled to interest as he otherwise would not be fully indemnified."

As to the law previous to that case Appendix A of the same volume states:

> "There have been three cases, viz., *ex parte* Wardell, and *ex parte* Hercy Cooke, 181, and *ex*

parte Badger, 4 Ves., 165, from which it has been supposed that a mortgagee when the security is insufficient is not entitled to apply the proceeds first to the payment of the interest accrued subsequent to the fiat. How far the cases warrant this doctrine and, if they did, how far it is tenable, the cases themselves on a moment's consideration of the principle will determine. Extracts of the cases from the books at the Bankrupt Office are subjoined. As to the principle it seems sufficient to say that a creditor who has a security where one debt is provable and the other is not provable has always been supposed to be entitled to apply his security to the debt which he cannot prove; *and it seems extraordinary to have been supposed, if it ever were supposed, that a mortgagee was to be in a worse situation because his security is insufficient.*"

As illustrative of the uncertainty of the rule in England down to as late a date as 1888 we would cite the case of *in re* Talbott (King *v.* Chick) in which it was held:

> "The mortgagee was entitled to have the proceeds of sale applied first in payment of interest on the mortgage debt down to the date of payment and then in payment of principal and to prove against the estate for the unpaid balance of principal."

Mr. Justice North delivering his opinion said:

> "In my opinion the plaintiff is entitled to be paid out of the proceeds of the security the amount which is due to him on receipt of his security including the interest down to the present time, the proceeds being applied first in payment of interest and then in payment of principal. For any balance of principal which may remain due to him, after this application of the proceeds of the security, he will be entitled to prove against the testator's estate, but without interest. If the proceeds of sale are more than enough

to pay the interest the estate will get the benefit of the surplus. If the proceeds of the sale are exactly equal to the interest, the mortgagee is entitled to retain the whole for interest. If the proceeds of sale were less than the amount of interest, the mortgagee would have to put up with the loss of the difference. In the present case the proceeds of sale will exceed the amount of the interest and he will be entitled to prove against the estate for the unpaid balance of the principal."

It is true that *in re* Savin, 7 Chan. App., 761, the Court of Appeals held this decision erroneous because of the early precedents, but it is nevertheless illustrative of the unsettled condition of the English law at least down to the time of the Savin case and also of the fact that the rule is predicated upon ancient decisions rather than founded in reason.

The utter unreasonableness of the English decisions is admirably illustrated by *In re* Quartermain, 1 Chan. Div., in which it was held that the income, but not the principal of securities, may be applied against interest accruing after the date of bankruptcy. Mr. Justice Sterling says as regards the application of the income:

> "*I confess that if the matter were res integra, I should have had some difficulty in holding that there was any difference between that and the proceeds of sale;* but it appears to me that I am bound by the decisions in Ex parte Ramsbottom (3) and Ex parte Penfold (4). Both cases were cited *In re* Savin, and no doubt was cast upon them. I have made a careful search, and cannot find that the rule there laid down has ever been overruled."

Learned counsel for the Appellant deems it his duty to attempt to rationalize what he calls this apparent exception to the rule. We will leave his noble efforts in this regard to the tender mercies of the Court, with the

suggestion that the English rule and the apparent exception while susceptible of historical explanation are impossible of rationalization.

We have here an instance of English legal conservatism which counts the following of precedents of greater importance than logic, symmetry or business convenience.

It is not our function to comment upon the social value of such national and class tendency, but as the proposition is a new one before this Honorable Court we respectfully submit that there is nothing in the English authorities which should induce this Court to overrule the decisions below.

The plain language of our own Statutes and the reasonableness of the Appellee's contentions were evidently the dominant factors in the decisions below. A desire to follow the English authorities because they were English, without regard to their reasonableness and in disregard of the fact that English legal conservatism merely as conservatism is not necessarily ground for ingrafting upon the bankruptcy law an unsound principle, will probably not appeal to this court.

An ambiguous and perhaps hasty expression of Lord Loughborough, hesitatingly but finally interpreted in the sense contended for by Appellant and followed by the English Courts is not necessarily the acme of human wisdom. Especially is this so when the so-called exceptions to the rule make logical consistency impossible as far as the English Courts are concerned. If the rule be adopted in America with its exception, then all the reasoning of Appellant in regard to the bankruptcy act and the desirability of equality among creditors fails of logical foundation since there can be no ground in the reason of things why dividends accruing on securities should be applicable to the payment of interest subsequent to the adjudication of bankruptcy, while the principal of such payment is inapplicable. The fact really seems to be that the English judges blundered along rather darkly from case to case and that no reconcili-

ation of their decisions with any consistent theory is at all possible. Energy misspent upon such reconciliations is at once one of the most painful as well as one of the most fruitless functions of the lawyer.

POINT III.

The French law is similar to the law as laid down by the court below.

The French Code Civil, section 1254, contains the same provision for marshalling assets as does our own. The Code of Commerce, Section 445 contains a provision similar to that of the Bankruptcy Law protecting the lien of creditors and allowing them to credit interest against the proceeds of security. This Section provides:

> "A judgment in bankruptcy stops interest as against the bankrupt estate on all debts not secured by a privilege, a pledge or a mortgage.
>
> Such interest on secured debts can only be claimed upon the amounts coming from the property affected by the privilege, the mortgage or the pledge."

Notwithstanding this apparently plain provision of the Statute several efforts were made to assimilate secured creditors to non-secured creditors in regard to interest and two decisions of the Court of Cassation sustain the view here contended for. These decisions are Credit Agricole C. syndic Bourson, Cass. Civ., 12 July, 1876, Sirey, Lois et Arrêts (1878), p. 68, and also Société Générale C. Synd. Courtignon, Cass. Civ., 13 July, 1896, Sirey, Lois et Arrêts, (1896) p. 395.

The latter decision sums up the proposition in the head note as follows:

> "The bankruptcy of the debtor in no respect alters the rights of a secured creditor and when the se-

cured creditor has received the interest on his debt as he has the right to do from the proceeds of the collateral the bankrupt estate cannot be considered to in any way affect the results of a distribution made in conformity with the rules laid down in Art. 1254."

Is there any reason why we should prefer the illogic and inconsistency of the British jurisprudence to the clear cut, symmetrical rule, sanctioned by the French Codes and the highest French Tribunal.

In a matter of first impression where it is necessary to lay down a guiding principle for future adjudication in a matter of general commercial law is there any reason why hesitating interpretations of Lord Loughborough's somewhat muddled order should be preferred to a plain, common-sense interpretation, reinforced as it is by the symmetrical and elegant jurisprudence of France?

Conclusion.

Summing up the above we conclude:

(1) That the Bankruptcy Act fairly interpreted requires that the principal enunciated in the decisions below be sustained;

(2) That the English decisions, by reason of the circumstances under which they originated, and their illogical and inconsistent character have no persuasive force;

(3) That the jurisprudence of France is in conformity with our own Statutes and enunciates a plain, simple rule, conforming to reason and the exigencies and convenience of modern business.

All of which is respectfully submitted this 28th day of December, 1910.

FREDERIC R. COUDERT,
Of Counsel.

APPENDIX.

UNITED STATES DISTRICT COURT,

SOUTHERN DISTRICT OF NEW YORK.

In the Matter of KESSLER & COMPANY, Bankrupts.	In Bankruptcy.

OPINION OF HAND, DISTRICT JUDGE.

JULY 7th, 1909.

In this case and in three others the Referee certified to the District Court the following question:

> "Is a creditor holding security which is liquidated after the filing of the petition entitled to interest upon his claim after the filing of the petition in bankruptcy where the proceeds of the sale of the security are inadequate to pay the face of the claim?"

Two other questions were likewise certified to the Court upon which the trustee was successful and which the claimant before the Court now waives. The Referee has allowed the secured creditor to marshall the proceeds of the security first against interest until the date of the liquidation of the security, and has then allowed proof for the balance of the claim after the remainder of the proceeds has been deducted. The amount of the security was much more than sufficient to pay all the accrued interest between the adjudication and the date of the liquidation of the security.

WALLACE MACFARLANE, for the Trustee.
RUFUS W. SPRAGUE, for the Claimant.

HAND, District Judge:

I cannot find that this question has been raised under the present Bankruptcy Act or under any of the other acts, although the negative of it has been the settled law for a long time in England. It is hardly necessary to cite authorities to show that the creditor, before the debtor's insolvency, has the right to marshall the security upon interest first and principal afterwards. This rule itself seems to have been in some doubt early in America, but it was laid down in the note on page 87 to Williams *v.* Houghtaling, in 3 Cowen, and I think it cannot be disputed that it is the law, generally speaking at present. It certainly was adopted by the Supreme Court in Story *v.* Livingston, 13 Pet., 359, 371, and it is quite obvious that otherwise the debtor might compel the creditor to leave the interest unpaid and keep reducing the principal. Moreover, the creditor, in the absence of any provision to the contrary, has, in general, the right to attribute payments as he pleases.

The Bankruptcy Act provides that liens, as would in justice necessarily be the case, shall not be affected by bankruptcy, and the mortgagee collects all interest upon his claims if the security is sufficient. Coder *v.* Arts, 152 Fed. Rep., 943, Sec. 57th, provides that the value of the securities shall be determined by converting them into money "according to the terms of the agreement pursuant to which such securities were delivered to such creditors."

The common law, being as it is, an implied term of the agreement under "which such securities are delivered," he may marshall the securities against interest, and that right is a part of the lien itself. The statute directs proof be made for the balance after the value as so ascertained is credited. The question comes down to what value shall be credited upon the claim. If the contract expressly provided that certain expenses of collection

should first be paid out of the security, I suppose no one will contend that bankruptcy will change that provision, and that the full value of the security must be credited upon the amount of the claim without first deducting those expenses allowed by the very agreement. I think interest is in the same category as any other deduction which the agreement may allow. By the implied term of the agreement, the creditor has the right before he pays any of the face of the claim to make certain deductions, among which is the deduction for interest accrued upon it; the balance is all that is applicable to payment. This is the course which the Referee has adopted, and I think he is right.

As I have said, the English law has for a long time been to the contrary, and, although this is not binding upon me, I should regard it as of the greatest moment, except in a case where the rule clearly arises through inadvertence, I say it with the utmost respect The rule appears to have originated in two cases, *ex parte* Wardell, 1787, and *ex parte* Hercey, 1792, not originally reported except in 1 Cooke's Bankruptcy Law, 4th Ed., 1799, p. 181. The full order made in each case may be found in Appendix A to 2 Montague and Ayrton, in which the learned reporters seem to indicate a doubt as to whether the cases in fact decided what they are said to decide in 1 Cooke's Bankruptcy Law, 181. I cannot, however, doubt that they are valid precedents, and the law seems to have started out with those two cases decided by the Chancellor squarely upon the point. No opinion, however, which has come down to the present time was given in either. In 1794, Lord Loughborough promulgated among his orders in bankruptcy, an order for the liquidation of securities by a mortgagee which is at least quite ambiguous upon this point in its language, 2 Cooke's Bank. Law, 4th Ed., p. 379. Indeed, from the language of this order, it would seem to follow that the creditor was entitled to prove for the whole deficiency. It is quite clear, too, that the order caused trouble at the bar, for in 1798 in *Ex Parte* Badger, 4 Ve-

sey, 165, the rule came for construction before Lord Loughborough (not Lord Eldon, as is stated in one of the later cases). Lord Eldon was at that time at the bar, and argued the case for the creditor. He conceded that the two cases in Cooke were against him, but he contended that the words of the order had raised doubt at the bar. Lord Loughborough, however, without discussion, construed his own order in accordance with *ex parte* Wardell and *ex parte* Hercey, and this seems to have settled the law in England from that time. In *ex parte* Ramsbottom, 2 Mont. & Ayrton, 80, Lord Eldon decided that the mortgagee must credit the full amount of the security against principal and interest up to the date of the commission, and the question came up upon appeal to the Court of Review in Bankruptcy as to whether the rents and profits arising from the security between the date of the commission and of the selling order should be credited upon interest which arose during the same period, or whether that, too, must be credited upon the face of the claim. To hold this was too much for the obvious justice of the situation and consequently the court, without much regard for consistency, held that the rents arising after the date of the commission should be credited against interest during the same period. This case is criticised in Appendix A to the volume in which it occurs by the learned reporters, and their criticism seems to be well founded. The analogy is apposite which they suggest, that where a creditor has security for two claims, one provable and the other unprovable, he may marshal his security against the unprovable claim. They very pertinently ask whether there is any valid distinction between that and the right to marshal the security against interest falling due after the date of the commission.

Re. Penfold, 4, J. DeG. & S. M., 282, however, follows the rule in *ex parte* Badger, as does also *Re.* Savin, 7 Chanc., 760, a case in the Court of Appeals. On the other hand, Justice North in the year 1888, in *re.* Talbot, 38 Chanc. Div., 567, made a contrary decision in

ignorance of *re.* Savin, but he is said to have subsequently thought he was in error, Quartermaine's Case, 1892, 1 Chanc. Div., 639. In the last mentioned case, Stirling, *J.*, wrote a long opinion, reciting the history of the law to some extent as I have stated it above and deciding in accordance with *Ex Parte* Badger. I think that settled the law beyond question, but if any doubt remained, it was settled by Justice Vaughan Williams, in *re* Bonacino, 1 Manson, 59 (1894). After that case there can be no doubt as to the rule in England.

As I have said, it was criticised, in my judgment, with great effect by the reporters in Appendix A, to 2 Mont. & A. and likewise the inconsistency was pointed out by Stirling, *J.*, in Quartermaine's case (*supra*), of allowing to be credited on subsequent interest the rents and dividends from the securities which fall due after adjudication. No doubt the increase on the security is a part of the security itself, and should follow the same rule, the only ground for an exception is that the increase between the date of the adjudication and the liquidation of the security is to be regarded as the return for the loss involved in waiting till it is realized, but, if so, consistency would require the result, that a security which bears no increase should be discounted as of the date of the adjudication, a proposition which no one has suggested.

If, however, my analysis of the situation at the outset of this opinion is correct, the rule itself is wrong. I have less hesitancy than I otherwise should in departing from it, in that we have no statement which has come down to us of the grounds of its original adoption. It is quite clear that the bar has considerable doubt as to the meaning of Lord Loughborough's order of 1794, and that doubt, I respectfully insist is much more than justified by the terms in which it was made. Lord Loughborough in settling the construction of that rule in *Ex Parte* Badger, avowedly only meant to follow precedents already in existence, which it is possible he may not have had in mind at the time the order was promulgated.

Under these circumstances in spite of the extremely persuasive character of any rule so well settled in English law, I cannot feel that it should be binding here.

Of course in a case in which the security was not sufficient to pay the interest which accrued upon the claim from the date of the adjudication until its liquidation, I do not mean to be understood to hold that the creditor could prove for any part of that interest remaining unpaid. In no event, could the creditor prove for more than the amount of the claim at the time of the adjudication. I only decide that the implied right given him under the original contract of marshalling the security in the first instance against the interest is not taken from him by the bankruptcy of the debtor.

The case of Commissioners *v.* Hurley, 169 F. R., 92, 94, does not in the least militate against the construction which I have placed upon Section 57 h.

In the other three cases the answer to the Referee's question will be likewise in the affirmative.

A. H.,

J.

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Supreme Court of the United States.

LAWRENCE E. SEXTON, as Trustee in Bankruptcy of KESSLER & COMPANY, Bankrupts. Appellant, *vs.* LLOYDS BANK, Ltd.	No. 663.

BRIEF FOR LLOYDS BANK, LIMITED, APPELLEE.

Statement of Facts.

Certain of the facts appearing in the record herein, material to this appeal and applicable to the appellee, Lloyds Bank, Limited, are not detailed in the appellant's statement of facts, and while appellant's statement so far as it goes is not controverted by the appellee, it is proper to supplement that statement briefly as follows:

This is an appeal from a final order of the Circuit Court of Appeals for the Second Circuit affirming an order of the District Court, which affirmed an order of the referee allowing the claim of Lloyds Bank, Limited, a secured creditor of the bankrupts Kessler & Company, for dividends, under Section 57-h of the Bankruptcy Act, in a balance due in

the sum of $4,520.81 after applying the proceeds realized from the sale of the security held by it. In the liquidation of its security the bank applied the proceeds in each instance, first to the accrued interest, and then to the principal (Rec., fols. 6, 33), and as these proceeds were sufficient to pay the interest, but not the entire principal, sought to prove its claim for this unpaid balance of principal. The security held by the bank against the indebtedness of the bankrupts to it was in the possession of the bank in Manchester, England, at the time of the filing of the petition in bankruptcy and the present consideration and good faith of the entire transaction is undisputed by the appellant. The single question raised by this appeal is as to the right of a partially secured creditor to apply the proceeds of collateral first to the interest on the debt accruing after the filing of the petition in bankruptcy and *up to and including the time of the sale of the collateral*, and then to apply any balance of the proceeds to the principal of the debt and finally to prove his claim as an unsecured and general creditor for the balance of principal due.

Various drafts amounting to upwards of $112,000 drawn by the bankrupts and outstanding and accepted by Lloyds Bank, Limited, prior to the 8th day of November, 1907, the date of the filing of the petition against Kessler & Company, fell due thereafter but were duly taken up and paid by Lloyds Bank, Limited, at their due dates respectively as late even as December 25th, 1907 (Rec., fols. 3, 32).

After the payment of the drafts by the bank, negotiations were undertaken with the trustee in bankruptcy of Kessler & Company by the attorneys for the bank in New York looking to the liquidation of the collateral held by the bank as security for the entire indebtedness of the bankrupts to it. It was

finally agreed that as almost all of the collaterals held by the bank were dealt in here and were not the subject of ordinary dealing in England, they should be realized upon in America, and in pursuance thereof the securities were thereafter sent over by the bank, and were disposed of in New York at various times between the 10th day of June, 1908, and the 2nd day of July, 1908, except $20,000 Mexican Central Railway which were sold in London and one U. S. of Mexico Bond redeemed in London (Rec., fols. 4, 5). The bank, nevertheless, prior to sending the collaterals to New York served a notice of demand and a notice of sale on the Stock Exchange in London. (Rec., fols. 4, 5). It is nowhere asserted by the trustee that the full and fair market value of these collaterals was not obtained from the sales above set forth.

The bank held the collaterals as security against any and all indebtedness of the bankrupts (Rec., fol. 2), and as each sale of the collateral was thus made by the bank the proceeds were credited by the bank as a partial payment, first against the interest due at that time and then the balance against the principal, each such partial payment being more than sufficient to cover the interest accrued to that date. Interest was then calculated on the balance of the principal remaining unpaid until the next sale of collateral and the same procedure again gone through with as each succeeding block of collateral was realized upon. The proceeds were insufficient to pay both the principal and interest of the debt and Lloyds Bank sought to prove its claim for the balance of the principal due and owing to it. The referee overruled the trustee's objection and allowed such proof and his determination was affirmed by both the District Court and by the Circuit Court of Appeals.

I.

The Bankruptcy Act expressly recognizes and preserves valid liens existing at the time of the filing of the petition.

Section 67–d of the Act of 1898, before the amendment of 1909, and as applicable to this case, read as follows:

> "Liens given or accepted in good faith and not in contemplation of or in fraud upon this act and for a present consideration, which have been recorded, according to law, if record thereof was necessary in order to impart notice, shall not be affected by this act."

This sub-section has been fully considered and upheld by this Court in *Hiscock* vs. *Varick Bank*, 206 U. S., 28.

The security was originally given to Lloyds Bank, Limited, by the bankrupts to secure the payment of both the principal and interest of the indebtedness (Rec., fol. 2). It follows that on November 8th, 1907, the date of the filing of the petition in bankruptcy, the lien on the collateral covering, as it did, the interest accruing to the actual date of the payment of the debt or to the date of the sale of the security, as well as covering the principal, was unaffected by the bankruptcy of the debtor. It is not contended by the appellant that the negotiations between him and the attorneys for the bank, resulting in the agreement above referred to, under which the security was brought to New York for sale and sold, varied, altered or affected in any way either the lien of the

appellee or the original agreement creating it. The contention made by the appellant in his brief would, if sanctioned by this Court, result in negativing the section 67d above quoted as the section would then be construed so as only partially to recognize the lien of the creditor.

II.

The Bankruptcy Act does not deny to the bank, a partially secured creditor, the right under its agreement to apply the proceeds of the security first to interest accruing on the debt after the filing of the petition and up to and including the time of the sale of the collateral, then to the principal and to prove for any balance remaining.

Section 63 of the Act of 1898 reads in part as follows:

> "SECTION 63. Debts which may be proved (*a*), debts of the bankrupts may be proved and allowed against his estate which are (1) a fixed liability, as evidenced by a judgment or an instrument in writing, absolutely owing at the time of the filing of the petition against him, whether then payable or not, with any interest thereon which would have been recoverable at that date or with a rebate of interest upon such as were not then payable and did not bear interest: * * * "

Appellant argues that the language of this section forbids the allowance of interest to a secured

creditor after the date of the filing of the petition. The section simply provides for the rebating of the principal of liabilities which do not become payable until after the filing of the petition and it must be read in connection with Section 67-d quoted above, and when so read it is apparent that section 63-a (1) can not refer to the rights of a secured creditor to take the interest granted to him by the terms of his valid agreement with the bankrupt when that agreement, either in express terms or by implication, allows the payment of interest up to the time of the payment of the debt or to the date of the liquidation of the collateral. The principal of the debt due to Lloyds Bank from the bankrupts was a fixed liability, absolutely owing within the meaning of Section 63-a (1).

Appellee submits that its application of the proceeds realized from the sale of the collateral held by it as stated above was in accordance with the rule laid down by this Court in *Story* v. *Livingston*, 13 Peters, 359, 371, which is as follows (p. 371) :

> " The correct rule in general is, that the creditor shall calculate interest whenever a payment is made. To this interest the payment is first to be applied; and if it exceed the interest due, the balance is to be applied to diminish the principal. If the payment fall short of the interest the balance of interest is not to be added to the principal so as to produce interest."

The same rule was adopted in *Merchants Bank* vs. *Freeman*, 15 Hun, 359, where it was said :

> " The rule for the computation of interest when partial payments are made requires that the interest should be first paid when the payment exceeds the interest ; and there is no exception that I am aware of to this rule of computation."

The result of this method of liquidation of the security and the application of the proceeds thereof to the indebtedness is that the claim allowed by the referee is for a balance of *principal* which was a fixed liability at the time of the filing of the petition herein. *No interest on this balance of principal was or is either claimed or allowed.*

It is the law as established by the following cases—*Coder* vs. *Arts*, 213 U. S., 223; *In re Stevens*, 173 Fed. Rep., 842; *In re Haake*, 11 Fed. Cases, 134, 2 Saw, 231, that if the security held by a creditor is sufficient to pay in full all interest accruing (subsequent to the filing of the petition in bankruptcy and up to the time of the sale of the collateral, as well as the principal of the debt, the creditor would be entitled to retain from the sale of the collateral an amount sufficient to pay all such interest as well as the entire principal and would be obligated to turn over to the trustee only such balance as might remain after such application of the proceeds from the sale of the security. The appellant contends, however, that inasmuch as the security held by this appellee was not sufficient to pay the interest after the filing of the petition as well as the entire amount of the principal, the rule is different and the bank is not entitled to apply the proceeds of the sale of the collateral first to such interest and then to the principal so far as it will go. This contention denies the rule laid down in *Story* vs. *Livingston* and *Merchants' Bank* vs. *Freeman* (*supra*). One reason advanced for this contention before the Circuit Court of Appeals by the trustee was that if a partially secured creditor were allowed to prove against the general estate for the remaining unpaid balance, he would then come into competition with the general creditors of the estate. We submit, however, that whether

the security is entirely sufficient to extinguish both the principal and interest and that is done; or whether it is insufficient to entirely extinguish both, and the unpaid balance is allowed for dividends, it is quite clear that in either case there is competition with general creditors. In the case of the fully secured creditor there is competition with general creditors since the creditor is paid in full, and the general estate is not increased by the amount of the interest accruing since the filing of the petition and up to the time of actual payment which otherwise he would have been obliged to pay over to the trustee. In the case of the partially secured creditor who is allowed to prove his claim for the unpaid balance, he is in competition with the general creditors of the estate to the extent only that he is allowed to receive dividends on the unpaid balance proved.

As to the degree of the competition, a fully secured creditor, since he takes all, is in greater competition with the general creditors of the estate than a partially secured creditor who is allowed to receive dividends only upon the unpaid balance.

A discussion of the question of interest by District Judge Wolverton in *In re Stevens* (*supra*) is in point in support of the appellee's contention. In that case a mortgagee was allowed interest on the mortgage debt up to the time of the sale by the trustee, with the consent of the mortgagee, of the premises mortgaged where the proceeds were sufficient to pay the principal and such interest, although this resulted in not paying in full labor claims having priority, and in cutting off entirely without dividends the general creditors of the estate. Judge Wolverton said (173 Fed., 842, 843):

"Subsequently, but for another purpose,

it is provided (subdivision "h") how the value of the security shall be determined, which is by converting the same into money in pursuance of the agreement by which the lien was created, or by agreement, arbitration, compromise or litigation, as the Court may direct. Thereupon it is declared that the value thus ascertained shall be credited upon the claim, 'and a dividend shall be paid only on the unpaid balance.' The balance, thus found due upon the secured claim which, in that event, would be only partially secured constitutes the amount of the creditor's claim against the estate of the bankrupt, and is made the basis for striking dividends as it respects the demand.

"The rule governing general claims against the estate, bearing interest, is that they will continue to draw interest to the date of the filing of the petition in bankruptcy, but not subsequent thereto. Such is the manifest intendment of the Bankruptcy Act itself, Section 63-a. * * *

"The rule is convenient, fair and equitable to all concerned, and affords a ready and indubitable basis for distribution of the assets under the provisions of the act among the creditors of the estate. By Section 67-d it is declared that liens given and accepted in good faith shall not be affected by the act. A lien in the usual course of business is given to secure interest accruing, as well as the principal of a demand, and it needs no argument to demonstrate the fact that, if the act should declare that interest shall cease upon secured demands at a given date, whether the demands are paid or not, it would affect the lien constituting such security. * * *

"The next inquiry is, then, when does the interest cease to run upon a secured claim? The manifest answer to this is, when the money is realized from the property pledged. That is the end of the proceeding, we might say, for foreclosing the lien, and the duty

> then devolves upon the trustee to pay the claimant his debt. The estate ought not to be burdened with the payment of interest subsequent to that time. Sturgis (the mortgagee) was, therefore, entitled to interest on his demand to the time the realty covered by his mortgage was sold and the money realized therefor with which to pay such demand."

The appellant relies upon the dictum of the Circuit Court of Appeals for the Eighth Circuit in *Coder* vs. *Arts*, 152 Federal, 943, 950, which is as follows:

> "Another rule, however, might prevail if the proceeds of the mortgaged property were insufficient to pay the mortgage debt and its interest in full and the mortgagee was seeking to collect the unpaid balance by sharing with other creditors in the distribution of the common property. He might not be entitled, then, to recover from the proceeds of the common property interest upon his debt to any later date than the unsecured creditors would recover interest upon their claims."

The bank is not seeking to recover *interest* from the proceeds of the common property to any later date than the unsecured and general creditors; *it is claiming dividends on a balance of principal only and upon the same footing as the general creditors of the estate.* It took its interest out of the property pledged by virtue of its agreement with the bankrupt, which could not be disturbed by the bankruptcy. Judge Hand said, in his opinion below in this case, when it was before the District Court (Rec., fol. 18, 171 Fed. Rep., 751, 754):

> "Of course, in a case in which the security was not sufficient to pay the interest which accrued upon the claim from the date of the

> adjudication until its liquidation, I do not mean to be understood to hold that the creditor could prove for any part of that interest remaining unpaid. In no event could the creditor prove for more than the amount of the claim at the time of the adjudication. I only decide that the implied right given him under the original contract of marshalling the security in the first instance against the interest is not taken from him by the bankruptcy of the debtor."

This appellee submits that the dictum of the Circuit Court of Appeals in *Coder* vs. *Arts*, above quoted, has no application to the case at bar. When the case of *Coder* vs. *Arts* came before this Court on appeal the dictum above quoted was not referred to. The doubt expressed by the dictum in *Coder* vs. *Arts*, above set forth, was evidently in the mind of Judge Hand when he wrote his opinion below in this case and was disposed of by him in the paragraph quoted above.

The right of a partially secured creditor to take his interest and prove for the balance due seems to have been taken for granted in *In re Peacock*, 178 Federal Reporter, 851, and in McHenry vs. La Sociéte Francaise, 95 U. S., 58.

An earlier case, *In re Strachen*, Federal cases No. 13519, seems to have allowed such interest.

In re Kallak, 147 Fed., 276, allowed interest on the taxes due from a bankrupt up to the time of the actual payment, and *In re Scheidt Bros.*, 177 Fed., 299, allowed a penalty imposed for non-payment of taxes after the filing of the petition.

III.

The Bankruptcy Act provides a remedy if a secured creditor unreasonably delays in the liquidation of the security held by him.

The appellant contends (Brief, pp. 13–14), that a secured creditor by delay in realizing upon security could eventually through the accumulation of interest, if interest subsequent to the filing of the petition was allowed him, entirely wipe out the security without diminishing the principal of his claim. Even if such a contention were sound in law, it is not his right to raise it upon this appeal. The collateral held by Lloyds Bank, Limited, was brought to New York for sale at his request and with his consent after notice of demand was served and notice of sale on the London Stock Exchange, and was sold in New York, as set out above, with all reasonable diligence under all the circumstances. There was no delay here which resulted in decreasing the amount realized from the sale of the collateral. The actual result of the delay was in favor of the bankrupt estate because of the increase in the amount of the proceeds from the sale of the security by reason of bringing the collaterals to an open market to be sold at a higher price. In any case, the hope and expectation of a larger return is the only reasonable motive to cause a creditor to delay in realizing upon the security held by him, since such creditor, and especially a creditor who foresees that he is only partially secured, cannot otherwise expect to be benefited by delay in the liquidation of his security.

The obvious answer in law to the appellant's contention is that Section 57-h of the Act of 1898 itself empowers the Bankruptcy Court, through the medium of agreement, arbitration, compromise or *litigation*, to forestall a fraudulent delay on the part of a secured creditor contrary to the terms of his agreement. This Court has said, in *Hiscock* vs. *Varick Bank*, 206 U. S., 28, 40, with reference to Section 57-h :

> " The Court was by this subdivision empowered to direct a disposition of the pledge property or the ascertainment of its value, where the parties had failed to do so by their own agreement. It is only when the securities have not been disposed of by the creditor in accordance with his contract that the court may direct what shall be done in the premises. Of course where there is fraud or a proceeding contrary to the contract the interposition of the court might properly be invoked."

In the Hiscock case, reported below, *sub nomine In re Mertens*, 144 Fed., 818, Judge Wallace says, at page 823 :

> " By the former Act (Act of 1867) it was provided that a secured creditor would be admitted as a creditor only for the balance of his debt after deducting the value of the pledged property ascertained by an agreement between him and the assignee in bankruptcy, or by a sale under the direction of the court. Under that provision, if the pledgee sold the pledged property prior to the appointment of the assignee, or without the permission of the court, he was precluded from proving his claim or obtaining any share of the bankrupt's estate to which he would otherwise have been entitled. The present act provides that the value of his security may be determined, among other methods, by

> converting it into money pursuant to his contract rights, and thus, if he has enforced it as the contract with the debtor allowed, he is permitted to prove the unsatisfied balance of his claim."

The appellee bank did sell the security held by it as its contract with the debtor allowed.

The power of the Court under Section 57-h as to the fixing of the value of the security by litigation was enforced in *In re Davison*, 179 Fed., 750, in which case, where the agreement under which the security, consisting of policies of insurance, was delivered to the creditor, contained no provisions for the ascertainment or determination of their value as security and where the trustee and secured creditor failed to reach an agreement as to their value the Court ordered that the value should be determined by litigation and the amount of value, so determined was deducted from the claim in ascertaining the amount on which the creditor was entitled to dividends from the bankrupt's estate.

This power of the Court to interfere to prevent a fraudulent exercise of a power of sale of pledged property by a secured creditor is commented on by District Judge McPherson *In re Browne*, 104 Fed., 762.

Lloyds Bank submitted to the jurisdiction of the Bankruptcy Court and duly filed its proof of debt, enumerating therein, as required by the Act, the securities which it held. All of these facts were within the knowledge of the trustee, who might have, under the Act, compelled the bank to liquidate the debt immediately if the rights of the general creditors were in danger of impairment.

IV.

The delay in the sale of the security was with the consent of the trustee, and the English rule has no application.

One notable exception, among certain others, to the rule of the English Courts forbidding the application of the proceeds realized by secured creditors of a bankrupt from the sale of the security held by them to interest accrued since the receiving order, is in a case where the delay after that date in selling the security is at the instance of the assignee. *Ex parte Kensington*, 2 Montague & A., 300, presents a decision upon the exact point. The creditors there holding sugars as security for their debt, delayed the sale thereof at the request of the assignee, and afterward, when the sugars had been sold, the creditors presented to the Court a petition praying that they be declared entitled to apply the sums realized, first in payment of the interest since the receiving order, and the Court, after due hearing, held that the creditors were entitled to the relief prayed by them.

See also *Ex parte Ramsbottom*, 2 Montague and A., 79.

In the case at bar, as pointed out hereinbefore, the security held by Lloyds Bank, Limited, was brought to New York and sold with the trustee's consent as it was finally agreed between him and the creditor, that such arrangement was for the benefit of all concerned by reason of the better market afforded in New York for the particular collaterals under consideration.

The English decisions have approved other exceptions to the rule relied upon by appellant, viz. :

(1) When the assignee disputes the security interest is allowed to the claimant.

Ex parte Pollard, 1 Mont. D. & D., 264.

(2) When there are two debts, the one provable, the other not, and the security was given to cover debts in general, the security may be applied in payment of the debts not provable.

Ex parte Kensington, 2 M & A., 300, 304.

3. The income of the security earned since the bankruptcy may be set off against interest on the debt accrued for the same period.

Ex parte Penfold, 4 De Gex & Smale, 282.

While there are several cases against the rule itself, it is not denied that such is the law to-day in England; but as Judge Hand said in his opinion in the District Court (adopted by the majority of the Circuit Court of Appeals), the rule clearly arose through inadvertence and is in no way controlling of the decision of this case.

For the foregoing reasons the order of the Circuit Court of Appeals herein should be in all respects affirmed, with costs.

October Term, 1910.

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